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In the

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1199

HYDROMETALS, INC.

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Hydrometals, Inc., petitioner, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on November 9, 1973.

OPINIONS BELOW

The per curiam opinion of the Court of Appeals for the Fifth Circuit appears in the Appendix hereto. It is unofficially reported at 73-2 USTC ¶9778. The opinion of the United States Tax Court, Memorandum Decision 1972-254, also appears in the Appendix hereto. It is unofficially reported at 31 TCM 1260.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered on November 9, 1973. This petition for certiorari was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Petitioner, to offset otherwise expiring net operating losses, assigned future manufacturing revenues from two of its operating divisions for a cash consideration of $1,300,000. The question is whether, as petitioner contends, income was realized by petitioner on the receipt of such cash payment, which receipt occurred on September 30, 1966. Respondent contends that the substance of the transaction was that of a loan, and, therefore, no income was realized upon receipt of the cash payment.

STATUTORY PROVISIONS INVOLVED

No statutory provision is directly involved.

STATEMENT OF THE CASE

Petitioner, herein referred to as taxpayer, was incorporated under the laws of the State of Illinois on July 30, 1908. Its principal place of business during the period from 1964 to date has been and is in Dallas, Texas. (R. 25).[1]

Taxpayer keeps its books and records and files its income tax returns on the accrual method of accounting. Taxpayer and its subsidiaries filed consolidated Federal income tax returns for its fiscal years ended September 30, 1966, and September 30, 1967, with the District Director of Internal Revenue, Dallas, Texas. (R. 25, 188, 251).

Until 1961 taxpayer was basically a producer and marketer of zinc products through its Illinois Zinc Company

[1] References are to the printed Appendix filed with the Court of Appeals for the Fifth Circuit.

Division. In its year ended September 30, 1965, petitioner disposed of this division. It is now a diversified manufacturer, the stock of which is listed on the American Stock Exchange. (R. 26).

During the taxable year ended September 30, 1966, taxpayer's operations were conducted through two subsidiaries and six divisions. One division, the Giller Tool Company Division, sells electronic kits, survival kits, safety equipment and tools, individually and in full kits, to the United States defense forces, local government and to industry. Giller also manufactures wooden chests and foot lockers. Another division, the Thomas Beckett Company Division, is one of the largest producers of fractional horsepower pumps in the world, shipping over 280,000 units annually. This division is also a leading manufacturer of floats and prefabricated duct work for the air conditioning industry. It also produces steel tool boxes. (R. 26-28) .

During its taxable year ended September 30, 1967, taxpayer continued to conduct the operations it had conducted during its 1966 year and also acquired U.S. Brass Company. This company manufactures and sells plumbing valves, flexible connectors and single lever faucets. (R. 28).

For its taxable year ended September 30, 1966 taxpayer had a net operating loss carryover from its taxable year ended September 30, 1961 in the amount of $1,928,557.59. This loss would expire at the end of the taxable year ended September 30, 1966 unless utilized to offset taxable income realized during such year. (R. 28).

The management of taxpayer was very aware of the possible expiration of the large loss carryover and, with taxpayer's accountants, the firm of Price, Waterhouse & Co., considered several methods of realizing income to offset the loss. Consideration was given to the sale of certain real property owned by taxpayer. Additionally, taxpayer considered acquiring oil and gas properties and thereafter carving out and selling an oil payment. Similar consideration was given to the acquisition of uranium properties. (R. 148).

It was finally decided that taxpayer should sell future manufacturing revenues and offset the proceeds of the sale against the otherwise expiring loss carryforward. Taxpayer was advised by Price, Waterhouse & Co. that the proceeds of such a sale would constitute ordinary income. Taxpayer was further advised, however, that as a prerequisite to the transaction resulting in the realization of ordinary income, there must be a bona fide sale and there could be no guarantee of any nature that the purchaser of the manufacturing revenues would have a return of his purchase price. (R. 54, 55, 78-80).

Taxpayer decided to offer for sale revenues from two of its divisions, the Beckett Division and the Giller Division. (R. 79).

Taxpayer approached several prospective purchasers of the manufacturing revenues, one of which was the Catholic Foundation, Dallas, Texas. Taxpayer's officers were aware that in the past the Catholic Foundation had acquired several oil payments in ABC and carved out oil payment transactions. In such transactions the Catholic Foundation had borrowed the funds with which to make the purchase. In fact, on numerous prior occasions Monsignor McGill, the executive director of the Catholic Foundation, had requested of the chief executive officer of taxpayer that the Catholic Foundation be considered as a prospective purchaser in the event taxpayer should have occasion to enter into a transaction similar to its oil payment transactions. Taxpayer therefore felt that the Catholic Foundation would be a prospective purchaser of the manufacturing revenues since it viewed the sale as being similar to the sale of a carved out oil payment. (R. 57, 80, 81, 110, 115).

Initially taxpayer and Monsignor McGill discussed the sale and purchase of $1,400,000 of manufacturing revenues for a discounted sales price of $1,300,000. Secondly, there was discussed the sale of approximately $1,300,000 of manufacturing revenues plus an additional amount of revenues equal to interest at a specified rate on the unliquidated balance of the principal sum. (R. 60, 86).

Taxpayer prepared and presented to Monsignor McGill projections of expected revenues from the two divisions. These were analyzed for Monsignor McGill by attorneys for the Catholic Foundation and were reviewed by the Board of the Catholic Foundation. Monsignor McGill personally visited and inspected the Giller plant and the manufacturing operations there being conducted. (R. 110, 111).

The projections reflected that upon the basis of the terms and proposals discussed the purchaser of $1,300,000 of manufacturing revenues together with an amount equal to interest at 8% on the unliquidated balance would receive all of the purchased revenues in approximately 11 to 12 months. (R. 89).

Taxpayer and Monsignor McGill were equally confident that the proposed purchase would pay out and result in a profit to the Catholic Foundation. However, each was fully aware and understood that the risk of loss, however appreciable, was with the Foundation in the event it made the acquisition. (R. 58, 59, 81, 82, 112).

Following negotiations between Monsignor McGill and taxpayer, and after a determination by the Board of the Catholic Foundation to acquire the manufacturing revenues, taxpayer, on September 30, 1966 assigned to Cathedral Foundation, Trust C a part of the manufacturing revenues of its Beckett and Giller divisions. There was assigned to Trust C seventy percent (70%) of the revenues from the two divisions until it received from the assigned revenues the sum of $1,300,000 plus an amount equal to interest on the unliquidated balance of said sum at the rate of 8% per annum. Cathedral Foundation, Trust C is a Catholic charitable trust, and is a part of the Catholic Foundation. As consideration for the assignment of such manufacturing revenues Cathedral Foundation, Trust C on September 30, 1966 paid to taxpayer the sum of $1,300,000. (R. 29, 108, 110, 111, 167).

Pursuant to the terms of the Assignment of Manufacturing Revenues taxpayer was obliged to continue the operations of the business in a good and workmanlike manner,

to cause the facilities to be maintained in a good state of repair and in good operating condition, to pay all costs, liabilities, expenses and taxes in connection with the operations, and to carry customary insurance coverage. (R. 167).

Cathedral Foundation, Trust C borrowed the funds with which to make the $1,300,000 payment to taxpayer from Texas Bank & Trust Company of Dallas, Texas (hereinafter called "Texas Bank"). During the period covered by its taxable years ended September 30, 1966 and 1967 Texas Bank was taxpayer's principal banking connection. Monsignor McGill decided to borrow the purchase price of the manufacturing revenue payment from Texas Bank because he was aware that it was taxpayer's principal banking connection and considered that such would facilitate the borrowing of the funds. (R. 29, 30, 113).

Cathedral Foundation, Trust C executed and delivered to Texas Bank its note in the principal amount of $1,300,000 bearing interest at the rate of 7% per annum. Cathedral Foundation, Trust C also executed and delivered to Texas Bank a Mortgage and Assignment securing the payment of the note by which there was assigned as security for the loan certain contracts and contract rights, and gross profits to be realized thereunder previously assigned by taxpayer to Cathedral Foundation, Trust C. (R. 29, 30, 176, 179).

The borrowing by Cathedral Foundation, Trust C was negotiated for and on behalf of Cathedral Foundation, Trust C by Monsignor McGill. (R. 28).

Upon receipt of the $1,300,000 payment from Cathedral Foundation, Trust C taxpayer acquired from Texas Bank three Certificates of Deposit, each bearing interest at 5%. One Certificate for $150,000 was due on November 15, 1966, another for $150,000 was due on December 15, 1966, and the other for $1,000,000 became due on January 15, 1967. Each of the three Certificates was issued in the name of taxpayer and was left with Texas Bank in safekeeping. By letter dated October 3, 1966, from taxpayer to Texas Bank it was stated that:

"This will constitute our agreement with and instruction to you that the above described Certificates of Deposit are to be retained in your possession until the maturities stated individually therein, at which time we will instruct you as to all or any part, thereof in one of the following two alternatives only:

1. Cashed to our account for application on our indebtedness, if any, due and owing to you at that time.

2. Cashed for reinvestment in new Certificate Deposits at your bank under similar terms and with this same letter of instruction."

(R. 31, 328).

Texas Bank requested that taxpayer pledge the Certificates as security for the loan to Cathedral Foundation, Trust C. Taxpayer refused to do so. Texas Bank also requested that the Certificates be issued in bearer form and be so held by the Bank as security for the loan. Taxpayer again refused to do so. (R. 64, 65).

Taxpayer did not guarantee or otherwise agree in any way to be responsible for the payment by Cathedral Foundation, Trust C of its obligation to Texas Bank. (R. 64, 65, 82, 88, 113, 131, 133).

During the period covered by its taxable years ended September 30, 1966 and 1967 taxpayer had a $1.5 million line of credit (reduced by borrowings from any other bank) at Texas Bank. On September 30, 1966 taxpayer owed Texas Bank $675,000 and Mercantile National Bank at Dallas $275,000. The funds received by taxpayer were used to acquire Certificates of Deposit rather than pay off existing debt as an accommodation to Texas Bank. By doing this, taxpayer felt it would improve its banking relationship and substantially increase its line of credit with Texas Bank. The Certificates of Deposit acted as compensating balances and thereby freed up funds that would otherwise be in a compensating balance. (R. 29, 89-91, 99).

Cathedral Foundation, Trust C received the entire amount of manufacturing revenues assigned to it by April 17, 1967. In total it received $1,338,907.25. (R. 31, 187).

In its income tax return for its taxable year ended September 30, 1966 taxpayer reported as taxable income the $1,300,000 received from Cathedral Foundation, Trust C. (R. 188).

The dominant motive for the transaction with Cathedral Foundation, Trust C was to offset the net operating loss carryover that would otherwise expire. (R. 28, 29).

The Tax Court relied upon its earlier decision in *J. A. Martin*, 56 T.C. 1255 (1971), which was affirmed per curiam (unofficially reported at 72-2 USTC ¶ 9637) by the Fifth Circuit, and held that in substance the transaction constituted a loan by Texas Bank through Trust C to taxpayer. Therefore, it was held that taxpayer did not realize income upon the assignment to Trust C of the manufacturing revenues. Before the Tax Court taxpayer agreed that the *Martin* case involved substantially the same situation and issue as taxpayer's case, but argued the decision in the *Martin* case was wrong. The decision of the Tax Court was appealed to the Fifth Circuit and such appeal was presented to the Fifth Circuit upon the record and briefs on file. The Fifth Circuit, without hearing oral argument, affirmed the decision of the Tax Court in a per curiam decision.

REASONS FOR GRANTING THE WRIT

1. The Decision Below Conflicts With the Decision of Another Court of Appeals.

The decision in this case is erroneous and directly conflicts with the recent decision in *Stranahan v. Commissioner*, 472 F. 2d 867 (6th Cir. 1973), reversing 30 TCM 1078 (1971).

In order to see how the conflict has arisen, it is necessary to summarize not only the decision in *Stranahan*, but also the decision in *J. A. Martin, supra*. Each case was a Tax Court decision of the issue in the case now before this Court,

involving whether the particular taxpayer effectively caused to be realized income by an assignment of future income for a consideration.

In the *Stranahan* case the taxpayer sold to his son $122,820 in anticipated stock dividends from common stocks owned by the taxpayer for a consideration of $115,000. The assignment was made by the taxpayer in an effort to realize income to offset a large interest deduction arising in the taxable year. The assignment of dividends was for so long a period as was necessary to receive dividends of the agreed amount, the company on whose stock the dividends were assigned had a long and consistent record of paying dividends, and the taxpayer and his son were familiar with the dividend records of the company as shareholders and employees.

In the *Martin* case the taxpayers, in order to offset current year's losses, assigned future rents to a trust in return for consideration in the amount of $225,000 plus a sum equal to 7% per annum computed from time to time on the unpaid balance of the $225,000.

In each case the Tax Court concluded, using basically the same legal reasoning, that in substance the particular transaction was a lending transaction and therefore the taxpayer did not realize income upon receipt of the consideration.

The Tax Court decision in *Martin* was affirmed per curiam by the Fifth Circuit. The Tax Court decision in *Stranahan* was reversed by the Sixth Circuit.

The case now presented to this Court was decided by the Tax Court after the Fifth Circuit affirmed *Martin*. Thus, the Tax Court followed its decision in *Martin*.

In the *Martin* case the Tax Court stated at page 1259:

> "A close look at the transaction reveals that the partnership retained, at all times, the ownership of the apartment building and 'assigned' only a specified dollar amount of future rents plus a specified interest on that amount. The 'assignment' did not result in any substantial change in the partnership's dominion and control

> over the property and no indicia of ownership in the apartment building were given to the Vannie Cook Trusts. In fact, Castle Gardens, Ltd., continued to lease the apartment building and collect the rents. Thus, when he caused the 'Assignment of Rents' agreement to be executed, J. A. Martin merely exercised, in advance, his power to dispose of the income from the apartment building. In other words, the partnership kept the 'tree' but claims to have assigned part of the 'fruit.' Under these circumstances, where there has been no effective separation of the 'fruit' from the 'tree,' the law clearly taxes income when and as received. Income from property is taxable to the owner of such property, and a mere assignment of the right to receive such income is not enough to relieve the assignor of the tax. *Helvering v. Horst*, 311 U.S. 112 (1940); *Arthur T. Galt*, 19 T.C. 892 (1953), affd. 216 F. 2d 41, 46 (C.A. 7, 1954), certiorari denied 348 U.S. 951; and *Iber v. United States*, 409 F. 2d 1273, 1276 (C.A. 7, 1969)."

Because of the reliance on *Martin*, the above language enunciates the legal premise upon which the decision in the case before this Court is based. The cases cited and the reasoning stated reveal that the Tax Court treated the *Martin* case and this case as if they involved *donative* assignments of income.

As seen from the following language by the Sixth Circuit, the Tax Court in *Stranahan* relied on substantially the same line of reasoning.

The Sixth Circuit reversed the Tax Court in *Stranahan* stating:

> "The Tax Court in its opinion relied on three cases. In *Fred W. Warner*, 5 B.T.A. 963 (1926), which involved an assignment by taxpayer to his wife of all dividend income respecting his 12,500 shares of General Motors Corporation stock, it was held the dividends

were income to the taxpayer and were not diverted to the wife through the purported assignment. However, this was a mere gratuitous assignment of income since apparently the only consideration for the assignment was ten dollars. *Alfred LeBlanc*, 7 B.T.A. 256 (1927), involved a shareholder-father assigning dividends to his son for as long as the son remained with the father's corporation. The Court held that in effect the father postdated his assignment to the dates when he was to receive dividends and hence the dividends were income to the father. However, here again it is apparent that at the time of the assignment there was no consideration. In *Trousdale v. Commissioner*, 219 F. 2d 563 (9th Cir. 1955), a taxpayer-partner attempted to convert future ordinary income into capital by selling his partnership interest. The Ninth Circuit determined that the sale of future partnership profits cannot be converted to capital gain but must be considered ordinary income. It is significant to note that the consideration for the assignment was recognized as ordinary income in the year the assignment was executed even though several outstanding accounts were apparently not collected in full until the following year.

"Hence the fact that valuable consideration was an integral part of the transaction distinguishes this case from those where the simple expedient of drawing up legal papers and assigning income to others is used. The Tax Court uses the celebrated metaphor of Justice Holmes regarding the 'fruit' and the 'tree', and concludes there has been no effective separation of the fruit from the tree. Judge Cardozo's comment that '[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it' *(Berkey v. Third Avenue Railway Co.*, 244 N.Y. 84, 94 (1926)) is appropriate here, as the genesis of the metaphor lies in a gratuitous transaction, while the instant situation concerns a transaction for a valuable consideration."

Preceding this statement the Sixth Circuit also made the following statements with respect to principles involved.

> 1. "A taxpayer who assigns future income for consideration in a bona fide commercial transaction will ordinarily realize ordinary income in the year of receipt. *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Hort v. Commissioners*, 313 U.S. 28 (1941)."
>
> 2. "A taxpayer is free to arrange his financial affairs to minimize his tax liability, thus the presence of tax avoidance motives will not nulify an otherwise bona fide transaction."

In this case taxpayer assigned future manufacturing revenues to Trust C for a full and valid cash consideration. Between taxpayer and Trust C the risk of loss with respect to whether Trust C would gain or lose on its investment was borne by Trust C. In *Stranahan* the issue was the same and the facts differed only in the type of income (future dividends) which was assigned and the relationship of the parties (father-son).

It is submitted that the decisions by the Sixth Circuit in *Stranahan* and in the case now before this Court are directly in conflict, that the decision by the Sixth Circuit in *Stranahan* is correct, and that the decision below is wrong.

2. The Decision Below Conflicts With a Prior Decision of this Court.

The decision by the Fifth Circuit is in conflict with *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958). In *Lake* the question before this Court was whether the assignment of an oil payment for a lump-sum consideration was taxable as ordinary income or entitled to capital gain treatment. In that case several transactions were involved. Most involved the following basic situation: There was assigned an oil payment right in a principal amount plus an amount equal to interest at a designated rate per year on

the unpaid balance remaining from month to month. At the time of assignment it could have been estimated with reasonable accuracy when the assigned oil payment right would pay out. Except for one of the transactions, a cash consideration was received by the assignor which was equal to the principal amount of the income to accrue during the term of the assignment, the assignee being compensated by interest on his advance.

This Court held the lump sum consideration was essentially a substitute for what would otherwise be received at a future time as ordinary income. This Court stated that the teaching of *Helvering v. Horst*, 311 U.S. 112 (1940), applicable to the case before it, was that if one entitled to receive at a future date interest on a bond or compensation for services makes a grant of it by anticipatory assignment, he realized taxable income as if he had collected the interest or received the salary and then paid it over. This Court then stated at page 267:

> "As we stated in *Helvering v. Horst*, *supra*, at 117, 'The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as a means of procuring them.' There the taxpayer detached interest coupons from negotiable bonds and presented them as a gift to his son. The interest when paid was held taxable to the father. Here, even more clearly than there, the taxpayer is converting future income into present income."

The ultimate holding was that taxpayer received ordinary income upon receipt of the lump sum payments.

The decision below rejects the "conversion of future income into present income" concept established in *Lake* and is therefore in conflict with *Lake*.

CONCLUSION

For the foregoing reasons, a Writ of Certiorari should issue to review the opinion and judgment of the Fifth Circuit.

Respectfully submitted,

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APPENDIX A

1. Opinion — Fifth Circuit

In the

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 73-2591

Summary Calendar*

HYDROMETALS, INC.,

Petitioner-Appellant,

VERSUS

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from a Decision of the Tax Court of the United States (Texas Case)

(November 9, 1973)

Before THORNBERRY, GOLDBERG and RONEY, Circuit Judges.

PER CURIAM: Upon consideration of the briefs and record, we AFFIRM on the findings and opinion of the Tax Court.

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*Rule 18, 5 Cir.; see Isbell Enterprises, Inc. v. Citizens Casualty Company of New York, et al., 5 Cir. 1970, 431 F. 2d 409, Part I.

2. Judgment — Fifth Circuit

United States Court of Appeals
FOR THE FIFTH CIRCUIT

October Term, 1973

No. 73-2591
Summary Calendar

T.C. No. 5855-69

HYDROMETALS, INC.,
Petitioner-Appellant,

VERSUS

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from a Decision of the Tax Court of the United States (Texas Case)

Before THORNBERRY, GOLDBERG and RONEY, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States Tax Court, and was taken under submission by the Court upon the record and briefs on file, pursuant to Rule 18;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decision of the United States Tax Court be, and the same is hereby affirmed;

It is further ordered that petitioner-appellant pay to respondent-appellee the costs on appeal to be taxed by the Clerk of this Court.

November 9, 1973

Issued as Mandate:

APPENDIX B

1. Memorandum Opinion — Tax Court

T. C. Memo. 1972-254

United States Tax Court

HYDROMETALS, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 5855-69.

Filed December 26, 1972.

J. W. BULLION and BUFORD P. BERRY, for the petitioner.

W. J. BLACKSHEAR, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, *Judge:* Respondent determined a deficiency in petitioner's Federal income tax for the taxable year ended September 30, 1967 in the amount of $410,420.20.

Certain issues raised by the parties in their pleadings have been resolved by agreement. The only remaining issue is whether petitioner should have reported $1,300,000 it received from sales in its fiscal year 1967 as taxable income in that year, or properly included the amount in its fiscal year 1966 as the price received for an assignment of future manufacturing revenues under an agreement it entered into with Cathedral Foundation, Trust C, a tax-exempt charitable trust.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Hydrometals, Inc. (hereinafter referred to as petitioner) was incorporated under the laws of the State of Illinois on July 30, 1908. Petitioner's principal place of business at the time of the filing of the petition in this case was and at all times since 1964 has been in Dallas, Texas.

Petitioner keeps its books and records and files its Federal income tax returns on an accrual method of accounting. Petitioner and its subsidiaries filed consolidated Federal income tax returns for its fiscal years ended September 30, 1966, and September 30, 1967, with the district director of internal revenue, Dallas, Texas.

Until 1961 petitioner was basically a producer and marketer of zinc products through its Illinois Zinc Company Division. In its year ended September 30, 1965, petitioner disposed of this division. It is now a diversified manufacturer. Its stock is listed on the American Stock Exchange.

During the taxable year ended September 30, 1966, petitioner's operations were conducted through two subsidiaries and six divisions. The operations of these subsidiaries and divisions during that year were as follows:

(1) Hydrometals International has its headquarters at Geneva, Switzerland, and is a subsidiary serving as an international licenser for Hydro-T-Metal, an alloy developed by petitioner. This product is patented in 37 countries.

(2) The Peru Mining Company is a subsidiary, the principal asset of which is all of the stock in the Shannon Mining Company. The Shannon mines at Gleeson, Arizona, contain proven deposits of silver, copper, and sulphur. Although these mines had not been worked for several years, petitioner in 1966 was evaluating either (a) reactivating the mines, due to rising prices of these materials, (b) selling the properties, or (c) trading them for another manufacturing company.

(3) Giller Tool Company became a wholly owned subsidiary of petitioner in 1964. Petitioner liquidated this subsidiary on September 30, 1965 and since that time its opera-

tions have been conducted by the Giller Tool Company Division. This division sells electronic kits, survival kits, safety equipment and tools, individually and in full kits, to the United States Military, local governments, and to private industry. Giller also manufactures wooden chests and foot lockers. The major purchaser for the Giller Division during the years 1966 and 1967 was the United States Government which purchased tools from this division on bid contracts for use in Vietnam.

(4) The Hydrographic Division distributes lithographic plates and chemicals to the printing trade.

(5) Lenfor Products Company is a division specializing in the manufacture of precision replacement parts for automotive transmissions.

(6) The Thomas Beckett Company was established in 1938. Petitioner acquired this company in 1962. This division of petitioner's operations is one of the largest producers of fractional horsepower pumps in the world, shipping over 280,000 units annually. This division is also a leading manufacturer of floats and prefabricated duct work for the air conditioning industry. It also produces steel tool boxes.

(7) The Roney Company was acquired as a division of petitioner in 1963. It manufactures high precision valves, fittings, gauges and couplings. Much of Roney's output goes to the butane and propane gas industry. In 1965 Roney perfected new valves for anhydrous ammonia fertilizer tanks and began marketing a new line of cylinder valves for the butane and propane gas industries, along with introducing a new underwater air valve for scuba divers. Roney's operations are reflected in the financial statements of the Beckett Division.

(8) Utility Pump Company is operated as a division. This division is a leading producer of plastic recirculating pumps and float valves for the evaporative cooler industry and, like Roney, the results of its operations are reflected in the financial statements of the Beckett Division.

During its taxable year ended September 30, 1967. petitioner continued to conduct the operations it had conducted during its 1966 year and also acquired the U. S. Brass Company. This company manufactures and sells plumbing valves, flexible connectors and single lever faucets.

Petitioner had a net operating loss carryforward from its taxable year ended September 30, 1961 of $1,928,557.59, which loss unless utilized to offset income which would otherwise be taxable, would expire during petitioner's taxable year ending September 30, 1966.

The management of petitioner was aware of the possible expiration of the loss carryover from petitioner's fiscal year 1961, and numerous discussions, including discussions with representatives of its accounting firm, were had concerning a method of utilizing the loss. Several methods of utilizing the loss including the possible sale of real estate or the possible acquisition of oil and gas properties or uranium properties from which a payment in kind might be carved out and sold were considered by petitioner's management.

Petitioner's accountants, Price Waterhouse & Co., advised petitioner that it should sell future receipts and offset the proceeds of the sale against the net operating loss carryover which would otherwise expire. Petitioner decided to offer for sale the revenues from two of its divisions, the Beckett Division and the Giller Division which were petitioner's principal revenue-producing divisions in 1966 and 1967.

Petitioner approached several prospective purchasers of its manufacturing revenues, one of which was the Cathedral Foundation, Dallas, Texas. Petitioner's officers were aware that the Cathedral Foundation had acquired with borrowed funds several oil interests in transactions involving carved out oil payments. One of petitioner's officers had on several occasions been requested by the directors of the Cathedral Foundation to consider the Foundation as a prospective purchaser if petitioner should have occasion to enter into a transaction similar to the oil transactions in which the Foundation had participated. The officers of petitioner and the

director of the Cathedral Foundation discussed the assignment by petitioner to the Foundation of $1,400,000 of manufacturing revenues for a discounted payment by the Foundation of $1,300,000 and also discussed the assignment to the Foundation of $1,300,000 of manufacturing revenues plus an additional amount of revenues equal to interest at a specified rate on the unliquidated balance of the principal sum.

Petitioner had prepared and presented to the Cathedral Foundation projections of expected revenues from its Beckett and Giller Divisions. These projections were examined by the executive director and attorneys for the Cathedral Foundation and were reviewed by the Board of the Cathedral Foundation. The projections reflected that under the terms of petitioner's proposal to the Cathedral Foundation, the Foundation would receive $1,300,000 of manufacturing revenues together with an amount equal to 8 percent of the unliquidated balance in approximately 11 or 12 months.

On September 30, 1966, petitioner and Cathedral Foundation, Trust C (hereinafter referred to as Trust C), a Catholic charitable trust, executed an instrument entitled, "Assignment of Manufacturing Revenues." On the same day petitioner also executed and delivered to Trust C, an instrument called an Assignment (hereinafter referred to as the Assignment).

The "Assignment of Manufacturing Revenues" executed by petitioner (referred to as the Seller) and Trust C (referred to as the Buyer) provided in part as follows:

> 3. *Assignment.* Seller, for and in consideration of the sum of $1,300,000.00 cash to it in hand paid by Buyer, receipt of which is hereby acknowledged, hereby sells, transfers, assigns and sets over to Buyer seventy percent (70%) of all Manufacturing Revenues [from its Beckett and Giller Divisions], as herein defined, that accrue to Seller after the Effective Date; subject, however, to the terms, provisions and limitations hereinafter set forth.

4. *Duration of Manufacturing Revenue Payment.* This Assignment shall remain in force until such time as Buyer shall have received and realized from Assigned Manufacturing Revenues actually received by Buyer after the Effective Date the full aggregate sum of the following amounts:

(a) The sum of $1,300,000.00; plus

(b) An amount computed (on the basis of a 365 day year) from the date hereof on the unliquidated balance of the Primary Sum at the rate of eight percent (8%) per annum, the first such computation to be made on November 15, 1966 and subsequent computations to be made on each Application Date thereafter.

5. *Application of Assigned Manufacturing Revenues.* All Assigned Manufacturing Revenues in the hands of Buyer on the day preceding any Application Date shall on such Application Date be applied, first, to the amount provided for in Section 4(b) above to the extent accrued to such Application Date, and, second, to the reduction of the unliquidated balance of the Primary Sum.

* * * * *

8. *Covenants of Seller.* Seller covenants and agrees with Buyer that until the Manufacturing Revenue Payment has been fully liquidated and discharged,

(a) Seller will cause its business to be continuously operated and maintained in good and workmanlike manner and in accordance with all generally approved practices in the industry and in strict conformity with all applicable federal, state and local laws, rules and regulations and will use its best efforts not only to maintain Manufacturing Revenues at their present level but to increase Manufacturing Revenues in the future;

(b) Seller will cause its facilities to be continuously maintained in a good state of repair and to

be kept in good and effective operating condition and all repairs, removals, replacements, additions and improvements thereof or thereto needful to such end to be promptly made and any required easements or right of ways to be obtained, whether by purchase, condemnation or otherwise;

* * * * *

(f) Seller will not assign, encumber or otherwise commit any Manufacturing Revenues or take any action or incur any obligation which will impair the ability of Seller to maintain and carry on its business and timely pay and discharge its obligations and liabilities out of Manufacturing Revenues not included in Assigned Manufacturing Revenues;

* * * * *

9. *Liability for Discharge.* Buyer shall look solely to Assigned Manufacturing Revenues for liquidation and discharge of the Manufacturing Revenue Payment and Seller shall not be personally liable for the payment thereof; provided, however, nothing herein contained shall relieve Seller of its obligation to respond in damages for any breach of any representation, warranty, covenant, agreement or obligation herein contained or arising hereunder.

On September 30, 1966, at the time petitioner executed the "Assignment of Manufacturing Revenues" and the Assignment, Trust C paid to petitioner the sum of $1,300,000 in cash.

Trust C borrowed all of the funds with which to make the $1,300,000 payment to petitioner from Texas Bank & Trust Company (hereinafter referred to as Texas Bank). Texas Bank is a large state bank doing a full service banking business in Dallas, Texas.

Trust C received the $1,300,000 from Texas Bank on September 30, 1966, at which time Trust C executed and delivered to Texas Bank its note due on or before one year from date in the principal amount of $1,300,000 bearing interest at the rate of 7 percent per annum. During

petitioner's fiscal years 1966 and 1967 Texas Bank was petitioner's principal banking connection.

Payment of the note executed by Trust C was secured by an instrument entitled, "Mortgage and Assignment" executed and delivered to Texas Bank on September 30, 1966. The instrument mortgaged and assigned to Texas Bank the right, title and interest of Trust C in the Assignment made to it by petitioner, which Assignment was attached as "Exhibit A" to the "Mortgage and Assignment."

The transaction between petitioner and Trust C and the transaction between Trust C and Texas Bank were closed on September 30, 1966, at the offices of Texas Bank. Prior to the closing, representatives of petitioner, Trust C, and Texas Bank had approved the form of the "Assignment of Manufacturing Revenues" and the instrument called an Assignment. The instrument referred to as an Assignment was prepared at the primary insistence of counsel for the Texas Bank as he thought it added to the collateral value of the "Assignment of Manufacturing Revenues." At the same time, representatives of Trust C and Texas Bank approved the "Mortgage and Assignment" executed by Trust C. No representative of petitioner was ever consulted with reference to the "Mortgage and Assignment" executed by Trust C.

Petitioner's dominant motive for the transaction with Trust C was to generate income in its fiscal year 1966 to offset its net operating loss carryover that would otherwise expire.

At the closing on September 30, 1966, at the offices of Texas Bank at which representatives of petitioner, Trust C, and Texas Bank were present, petitioner executed and delivered the "Assignment of Manufacturing Revenues" and the Assignment to Trust C. Trust C then executed and delivered the "Mortgage and Assignment" to the Texas Bank. Texas Bank then concurrently deposited $1,300,000 in the account of Trust C and pursuant to instructions

from Trust C, Texas Bank debited the account of Trust C with $1,300,000 and credited a deposit of $1,300,000 into the checking account of petitioner with Texas Bank.

During its fiscal years ended September 30, 1966, and September 30, 1967, petitioner had a line of credit of $1,500,000 (reduced by borrowings from any other bank) with Texas Bank. On September 30, 1966, petitioner owed Texas Bank $675,000 and Mercantile National Bank of Dallas $275,000. At the time Trust C commenced negotiations with Texas Bank for a loan on the security of the Assignment of Manufacturing Revenues made by petitioner to Trust C, it was aware that Texas Bank was petitioner's principal banking connection.

Pursuant to a representation made by petitioner to Texas Bank at the closing on September 30, 1966, petitioner, on October 3, 1966, purchased from Texas Bank three certificates of deposit each bearing interest at 5 percent and aggregating $1,300,000. One certificate for $150,000 was due on November 15, 1966, another for $150,000 was due on December 15, 1966, and the other for $1,000,000 became due on January 15, 1967. The three certificates were all issued in petitioner's name. Petitioner left them with Texas Bank and Texas Bank issued to petitioner its customary safekeeping receipt.

The minutes of the Senior Loan Committee of Texas Bank, dated October 4, 1966, contain the following discussion concerning the loan of $1,300,000 to Cathedral Foundation Trust C:

> This request for new money is to discount a gross pront payment purchased, by Cathedral Foundation Trust C, from Hydrometals, Inc. This ABC transaction is secured by assignment of 70% of the gross profits of Hydrometals, Inc. to Cathedral Foundation Trust C. In addition we are to receive a negative pledge agreement on $1,300,000.00 C/D at 5%, and held in safe keeping. In addition, we are to receive an assignment of the proceeds under government contract

work if assignable, and if not an assignment of non-government contract proceeds in sufficient amount to collateralize this loan. Profitability on this line has been computed at 1.10%.

APPROVED.

A letter from petitioner to Texas Bank, dated October 3, 1966, contains the following statement:

> This will constitute our agreement with and instruction to you that the above described Certificates of Deposit are to be retained in your possession until the maturities stated individually therein, at which time we will instruct you as to all or any part, thereof in one of the following two alternatives only:
>
> 1. Cashed to our account for application on our indebtedness, if any, due and owing to you at that time.
>
> 2. Cashed for reinvestment in new Certificate Deposits at your bank under similar terms and with this same letter of instruction.

Petitioner paid, and Trust C received, all of the moneys it was entitled to receive under the provisions of the "Assignment of Manufacturing Reserves." The final payment was made on April 17, 1967, at which time Trust C had received $1,338,907.25 representing the total primary sum of $1,300,000 and an additional amount of $38,907.25.

On its Federal income tax return for its taxable year ended September 30, 1966, petitioner reported as taxable income the sum of $1,300,000 received from Trust C. On its return for its fiscal year 1966 it showed a taxable income before net operating loss deduction of $2,059,876.72, a net operating loss deduction of $3,308,771.10 and under "taxable income" showed a loss of $1,248,894.38.

Petitioner on its Federal income tax return for its fiscal year ended September 30, 1967, did not include in its gross

receipts the $1,300,000 paid to Trust C under the "Assignment of Manufacturing Revenues." Respondent in his notice of deficiency for petitioner's fiscal year 1967 increased petitioner's income as reported by $1,300,000 with the explanation that petitioner had erroneously omitted this amount "of gross manufacturing income which was produced and realized in this year, but which was erroneously treated as income of the taxable year ended September 30, 1966."

OPINION

Petitioner takes the position that its assignment of manufacturing revenues to Trust C was in both form and substance a sale for a consideration of $1,300,000. Respondent, on the other hand, contends that the transaction between petitioner and Trust C was merely an attempt by petitioner to assign future income and that petitioner must in computing its taxable income include this income in 1967 when the manufactured goods were sold. Respondent states that the transaction between petitioner and Trust C was in the nature of a loan by the Texas Bank through Trust C to petitioner bearing interest at 8 percent, the loan to be repaid by an assignment of manufacturing revenues.

Both parties cite the case of *J. A. Martin*, 56 T.C. 1255 (1971), affirmed per curiam, F. 2d (C.A. 5, Aug. 18, 1972). At the time the parties filed their briefs in this case, the United States Court of Appeals for the Fifth Circuit had not rendered its opinion in the *Martin* case.

The taxpayers in the *Martin* case were members of a partnership which owned an apartment building from which it received rental income. The taxpayers were also members of another partnership which during the year 1966 sustained large losses. In order to reduce their Federal income tax, the taxpayers had the partnership which owned the apartment building enter into an agreement as of December 27, 1966, to assign rents to be received in the following year to a trust in return for an advance of $225,000 from the

trust to the partnership. The amount of the advance, with a secondary sum of 7 percent of the unpaid balance of the primary sum, was to be returned to the trust in the following year or years solely from the assigned rents. The taxpayers in the *Martin* case contended that the $225,000 constituted proceeds from the sale in the year 1966 of rents to be received by the partnership and that the $225,000 was properly includable in the partnership income in 1966, whereas the Commissioner argued that the transaction was in substance a loan to the partnership and that the partnership received the rental income in 1967 and paid it over in discharge of the loan. We held that in substance the transaction constituted a loan. We pointed out that in effect the partnership merely exercised in advance its power to dispose of the income from the apartment building, and that the cases relied on by the taxpayer including the case of *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), were inapposite to the transaction there involved.

There is no substantive distinction between the situation involved in *J. A. Martin, supra,* and that involved in the instant case. In fact, petitioner does not contend that there is any substantive distinction in fact or in law in *J. A. Martin, supra,* and the instant case, but rather contends that our decision in *Martin* is incorrect and should not be followed. The *Martin* case has now been affirmed by the United States Court of Appeals for the Fifth Circuit, the Circuit to which an appeal in this case would lie. We are therefore required in this case to follow our holding in *J. A. Martin, supra,* as affirmed by the Fifth Circuit. See *Jack E. Golsen,* 54 T.C. 742 (1970), affirmed 445 F. 2d 985 (C.A. 10, 1971).

However, in our view, our holding in *J. A. Martin, supra,* is correct and for that reason should be followed in this case. We hold in this case that the transaction between petitioner and Trust C was in substance merely a loan by the Texas Bank through Trust C to petitioner with repayment to be from 70 percent of the manufacturing revenues from peti-

tioner's Beckett and Giller Divisions. Trust C did not "buy" a property which it could retain and which might fluctuate in value. All that Trust C acquired was the right to be repaid $1,300,000 with interest at 8 percent, which $1,300,000 it had in form borrowed from Texas Bank at 7 percent interest and had deposited in petitioner's bank account. Texas Bank was to be repaid by Trust C as Trust C was repaid through the assigned manufacturing revenues.

Petitioner argues that it in no way guaranteed the repayment of Trust C's loan to Texas Bank. In our view the facts do not support this contention of petitioner. Petitioner left for safekeeping with Texas Bank certificates of deposit for $1,300,000 which it had purchased with proceeds it received from the loan made by Texas Bank to Trust C. There was in effect an agreement between petitioner and the bank that these certificates would be maintained until Trust C had repaid the $1,300,000 to Texas Bank. Furthermore, considering the nature and type of sales made by petitioner's Beckett and Giller Divisions, the assignment of 70 percent of these sales was substantial collateral for the loan of Texas Bank to Trust C. Under the facts shown in this record there existed no real possibility of a failure of sufficient amounts from the assigned manufacturing revenues to make the $1,300,000 repayment to Texas Bank.

Sun Properties v. United States, 220 F. 2d 171 (C.A. 5, 1955), relied on by petitioner involved a bona fide sale and therefore has no relevance to the instant case which involves a transaction which in our view is not in substance a sale. Cf. *Bryant v. Commissioner*, 399 F. 2d 800 (C.A. 5, 1968), affirming 46 T.C. 848 (1966). Because of certain issues having been disposed of by agreement of the parties,

Decision will be entered under Rule 50.

B-14

In the

Supreme Court of the United States

OCTOBER TERM, 1973

No. .....

HYDROMETALS, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

CERTIFICATE OF SERVICE

I hereby certify that on this 31st day of January, 1974, four copies of the Petition for a Writ of Certiorari were mailed by air mail, postage prepaid, to the Solicitor General, Department of Justice, Washington, D. C. 20530 and on the same day two copies of said Petition were mailed by air mail, postage prepaid, to Scott P. Crampton, Esquire, Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D. C. 20530. I further certify that all parties required to be served have been served.

s/ John W. Rutland Jr.

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